Internal Revenue Service

memorandum

CC:DOM:FS:FREV-106073-97
CORP:GRGLYER

date: July 15, 1997

to: Chief, Branch 5 Assistant Chief Counsel (International)
Attn: Milton Cahn

from: Assistant Chief Counsel (Field Service)

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subject: [redacted]

This is a written response to your request for assistance, dated April 10, 1997.

ISSUE

Whether Profit Participation Rights (PPR") issued by [redacted] to its shareholders, which were originally classified by [redacted] as equity and later reclassified by [redacted] as debt, should be classified as debt or equity for purposes of determining [redacted]'s liability to asset ratio under Treas. Reg. § 1.882-5.

RECOMMENDATION

The PPRs should continue to be classified as equity for two reasons. First, the investment of a holder of a PPR is subject to the risk of the operations of [redacted]. Second, [redacted] initially treated the PPRs as equity and cannot change that characterization for the sake of gaining a tax advantage.

FACTS

[redacted] is owned [redacted]% by the [redacted], and [redacted]% by the [redacted]. [redacted] has no capital stock outstanding.

From [redacted] through [redacted], [redacted] issued Profit Participation Rights, ("PPRs") to its two shareholders. According to the documents submitted, the holder of a PPR has the right to participate in the profit and must also suffer in any loss, of [redacted]. For example, [redacted] will pay the holder of a PPR a stated rate of return if its profits will cover this payment. If a loss occurs or if payment of the interest will result in a loss, then no payment is made and the loss is deducted from the capital represented by the

PPR as a proportion of its book value compared to any other capital of [redacted]. When a profit is again made, then the payments will be made after the capital is restored.

Through [redacted], there were [redacted] series of PPRs issued totalling [redacted], as follows:

Loan	Amount	Year Issued	Year Matured	Rate
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

The first [redacted] series of PPRs were issued exclusively to the shareholders of [redacted] according to their participation in capital, i.e., pro rata. Series [redacted] through [redacted] were offered first to the shareholders of [redacted] proportionately and then to the public on the [redacted] Stock Exchange (we do not have any information as to amount of these series purchased by the public), as follows:

Series	Amount	[redacted]	ABSB
[redacted]	[redacted]	[redacted]	[redacted]

On its [redacted] and [redacted] U.S. tax returns, [redacted] showed the PPRs as part of the equity capital in calculating its ratio of worldwide liabilities to assets under Step 2 of Treas. Reg. § 1.882-5 (see Treas. Reg. § 1.882-5(c)). Beginning in [redacted], [redacted] changed the classification of its PPRs to liabilities (i.e., debt), thereby increasing its ratio to [redacted]% (we do not know what the prior ratio was or what the amount at issue is). You have asked the proper classification of the PPRs.

DISCUSSION

This case raises two issues: (1) whether the PPRs should be classified as equity, and (2) whether [redacted] is precluded from reclassifying the PPRs as debt after having originally treated them as equity.

The Debt/Equity Issue:

The characterization of an instrument as debt or equity is usually considered a question of fact and the taxpayer has the

burden of proof. See, e.g., Raymond v. United States, 511 F.2d 185 (6th Cir. 1975); McSorley's, Inc. v. United States, 323 F.2d 900 (10th Cir. 1963). See also Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1981). The ultimate factual inquiry is whether the parties intended to create a debtor/creditor relationship and, if so, whether that intention was economically reasonable. Initially, [redacted] characterized the PPRs as equity (on its [redacted] and [redacted] U.S. tax return). Thus, initially, [redacted] intended to treat the PPRs as equity.

Several years later, [redacted] characterized the PPRs as debt. You have indicated that [redacted] argues that its original classification of the PPRs as equity was incorrect. Thus, [redacted] changed the characterization of the PPRs to debt. This recharacterization of the PPRs made [redacted]'s ratio (under step 2 of Treas. Reg. § 1.882-5) more favorable to [redacted] than it would have been if it had continued to characterize the PPRs as equity. As discussed in the next section of this memo, parties are held to their consistent characterization of an instrument.

The PPRs are subject to strict scrutiny because they are between related parties and were held in proportion to equity (at least in the early years). See Matter of Uneco, Inc. v. United States, 532 F.2d 1204, 1207 (8th Cir. 1976) (quoting Cayuna Realty Co. v. United States, 382 F.2d 298 (Ct. Cl. 1967)) ("Advances between a parent corporation and a subsidiary or other affiliate are subject to particular scrutiny 'because the control element suggests the opportunity to contrive a fictional debt'"). See also P.M. Fin. Corp. v. Commissioner, 302 F.2d 786, 789 (3d Cir. 1962) (sole shareholder-creditor's control of corporation "will enable him to render nugatory the absolute language of any instrument of indebtedness") and Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968). See also Charter Wire, Inc. v. Commissioner, 309 F.2d 878, 880 (7th Cir. 1962), cert. denied, 372 U.S. 965 (1963) (debt held in proportion to equity interests raises a "strong inference" that the debt instrument reflects an equity investment); Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957); Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957).

More specifically, in the first two years ([redacted] and [redacted], [redacted]'s two shareholders subscribed to the PPRs pro rata. During the next two years ([redacted] and [redacted], [redacted]'s shareholders subscribed to the PPRs on an essentially pro rata basis. For the remaining two years for which we have information ([redacted] and [redacted], the PPRs were subscribed disproportionately (and not at all by one shareholder for the last [redacted] series). We do not have any information as to why these later subscriptions of the PPRs were disproportionate. In addition, some portion of these series of the PPRs were purchased by the public, although we do not know the amount. In any event, because of the presence of other equity elements in the PPRs (and their treatment by [redacted] as equity

in the early years), we do not believe that the disproportionate nature of these later subscriptions affects the analysis.

However, the most important factor in evaluating the character of the PPRs is that the shareholders considered their money to be at the risk of the business, which is an element of equity. See, e.g., Sherwood Memorial Gardens, Inc. v. Commissioner, 42 T.C. 211 (1964), aff'd, 350 F.2d 225 (1965). As noted above, the shareholders would only be paid purported interest if [redacted] earned sufficient income to pay such amounts. You have indicated that, so far, [redacted] has earned sufficient income to pay all of its purported interest. Nevertheless, if [redacted] had not earned sufficient income to pay the purported interest, then the capital accounts of the shareholders would have been reduced by such amounts. Subsequently, such accounts would have to have been replenished before any additional purported interest could be paid to the shareholders. Thus, the PPRs are similar to preferred stock. By contrast, debtholders expect to be paid interest and repaid their principal whether or not the borrowing business makes money.

The Consistency Issue:

As noted above, [redacted] initially treated the PPRs as equity and later recharacterized them as debt. The question is whether [redacted]s initial characterization of the PPRs as equity precludes it from later recharacterizing the PPRs as debt.

As noted above, prior to the audit, [redacted] treated the PPRs for financial purposes and tax reporting as equity. [redacted] argues that, irrespective of the labels originally attached to the PPRs, they were, in substance, debt. [redacted] argues that it is now entitled to disavow the form of its transaction.

It is a well known axiom of tax law that taxpayers are free to structure their transactions in a manner that will result in their owing the least amount of tax possible. However, the Supreme Court observed in Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974):

> that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so he must accept the tax consequences of his choice, whether contemplated or not, * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not. [Citations omitted.]

See also Television Indus., Inc. v. Commissioner, 284 F.2d 322, 325 (2d Cir. 1960), aff'g 32 T.C. 1297 (1959).

Taxpayers have, however, been permitted to assert substance over form in situations where their "tax reporting and other

actions have shown an honest and consistent respect for * * * the substance of * * * [a transaction]". FNMA v. Commissioner, 90 T.C. 405, 426 (1988) (citing Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1430 (1986)), aff'd 896 F.2d 580 (D.C. Cir. 1990).

[redacted] has, for all purposes, treated the PPRs as equity. Under those circumstances, we believe the Tax Court would reject [redacted]'s approach of testing its own choice of form with traditional debt versus equity considerations, such as the absence of a fixed payment schedule, maturity dates, enforcement, or formal debt instruments. See Taiyo Hawaii Company, Ltd. v. Commissioner, 108 T.C. #27 (06/25/97). We also believe that the Court would not be persuaded by [redacted]'s representative's after-the-fact statement to you that, in retrospect, he should have considered the PPRs as debt and reported them as such on [redacted]'s tax returns.

We believe that [redacted]'s approach does not show that the substance of the PPRs was that of debt, rather than equity. It merely illustrates that the parties to the transactions did not follow all of the formalities that might be considered probative that the PPRs were debt rather than equity. In that regard, we believe that [redacted] has not shown that the equity form of the transaction did not comport with its substance. See Taiyo Hawaii Company, Ltd. v. Commissioner.

Accordingly, we believe that [redacted] has not carried its burden of showing that the substance of the transaction was different from its equity form. Elrod v. Commissioner, 87 T.C. 1046, 1066 (1986); Pritchett v. Commissioner, 63 T.C. 149, 171 (1974) (citing Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959), aff'g 29 T.C. 129 (1957)); Estate of Durkin v. Commissioner, T.C. Memo. 1992-325, supplemented by 99 T.C. 561, 572 (1992); see also Estate of Corbett v. Commissioner, T.C. Memo. 1996-255.

As the Tax Court noted in Taiyo Hawaii Company, Ltd. v. Commissioner, other courts have held, in certain instances, that taxpayers may not cast a transaction in one form, file returns consistent with that form, and then argue for an alternative tax treatment after their returns are audited. See Investors Ins. Agency, Inc. v. Commissioner, 677 F.2d 1328, 1330 (9th Cir. 1982), aff'g 72 T.C. 1027 (1979); McManus v. Commissioner, 583 F.2d 443, 447 (9th Cir. 1978) ("A taxpayer is estopped from later denying the status he claimed on his tax returns."), aff'g 65 T.C. 197 (1975); Parkside, Inc. v. Commissioner, 571 F.2d 1092 (9th Cir. 1977), rev'g T.C. Memo. 1975-14; In re Steen, 509 F.2d 1398, 1402-1403 n. 4 (9th Cir. 1975); Demirjian v. Commissioner, 457 F.2d 1, 5 n. 19 (3d Cir. 1972), aff'g 54 T.C. 1691 (1970).

In its tax and financial reporting and other actions, we believe that [redacted] has not demonstrated an honest and consistent respect for what it now contends was the substance of the transaction. Comdisco, Inc. v. United States, 756 F.2d 569, 578

(7th Cir. 1985); Estate of Weinert v. Commissioner, 294 F.2d 750, 755 (5th Cir. 1961), rev'g and remanding 31 T.C. 918 (1959); FNMA v. Commissioner, supra at 426. Accordingly, [redacted] should be required to continue to recognize its treatment of the PPRs as equity.

If you have any questions regarding this matter, please contact Grid Glyer at 202-622-7930.

DEBORAH A. BUTLER
Assistant Chief Counsel
(Field Service)

By: _____
ALFRED C. BISHOP, JR.
Chief, Corporate Branch
Field Service Division

Internal Revenue Service

memorandum

CC:INTL:Br5: FREV-106073-97
MMCahn

date: JUL 31 1997

to: Susan L. Graham, Internal Revenue Agent

from: Jeffrey Dorfman, Chief, Branch 5
Associate Chief Counsel (International)

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subject: [redacted]

DISCLOSURE LIMITATIONS

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This is in response to your request for field service advice dated March 25, 1997 in which you suggest that the instruments described below be treated as equity for purposes of step 2 of the §1.882-5 regulations.

A summary of the facts submitted is as follows. [redacted], a foreign bank, issued the instruments at issue. [redacted] is owned [redacted]% by the [redacted], and [redacted]% by the [redacted]. The instruments

were generally issued in [redacted] series, over a period of [redacted] years, to the two owners in proportion to their ownership in the bank.

The instruments at issue are called profit participation rights. The rights generally mature in ten to twelve years after issue, but they are subordinated to [redacted]'s debt.

The profit participation rights pay interest at varying rates ranging from [redacted]% to [redacted]%, depending upon the specific series. The interest, however, is only payable if the bank has sufficient profits to cover the payment. If a loss occurs, or if the payment of interest will result in a loss, no payment is made, and the loss is deducted from the capital of the bank. The loss is allocated between the capital represented by the profit participation rights and other bank capital based on the ratio that the profit participation rights bear to the total bank capital. When a profit is made in later years, interest is paid only after the capital is restored.

In its [redacted] and [redacted] tax returns [redacted] characterized the profit participation rights as equity for purposes of step 2 of the 1.882-5 regulations. In [redacted] the bank changed its classification of the instruments from equity to debt.

The issue presented, which involved the determination of whether the profit participation rights were classified as debt or equity, is not within our jurisdiction. Accordingly, we sent for assistance from CC:DOM:FS:CORP. The assistance concludes that the profit participation rights should be characterized as equity. We agree with this conclusion. A copy of the assistance is attached for your convenience.

If you have any questions, please contact Milton Cahn at (202) 622-3870.